Risk Management in Public Private Partnerships

Presentation: Public Sector Risk Management Forum
Date: 06 March 2014
Developing a Risk Matrix for PPPs
Worldwide experience indicates there are certain requirements before a government can successfully use PPPs to procure public services infrastructure. South Africa has met these requirements:

- A detailed legislative framework in place
  - Public Finance Management Act
  - PFMA Treasury Regulation 16
  - Municipal Finance Management Act
  - Local Government: Municipal Systems Act
  - Municipal PPP Regulations
- A functioning judicial/legal system
- Capacitated, enthusiastic government officials
- Demonstrated capable private sector interest; and
- An enabling PPP framework
  - PPP Manual
  - Standardized PPP Provisions
  - Municipal Service Delivery and PPP Guidelines
  - Tourism Toolkit
A highly capacitiated PPP Team in Place

- Informed by the Partnerships UK model
- Until 31 March 2013, was a division of the Budget Office Directorate in National Treasury
- Now Part of GTAC – Government Technical Advisory Centre -- a “component” under South African law
- 100% “owned” by National Treasury
- Report to the Acting GTAC CEO who reports directly to the Minister of Finance
- Head of PPP Team is a Chief Director
The South African PPP Team has closed 26 PPP projects in these sectors—

- Health Care, including medical equipment installation, operation and maintenance, hospital co-location, provision of renal dialysis services and hospital refurbishment, maintenance and operation at various hospitals
- Office Accommodation, for the financing, design, construction, maintenance and operation of office accommodation facilities for government departments
- Toll Roads, for commercial and tourism activities
- Social Grants, for the distribution of social grants, including the accounting thereof
- Fleet Management, for the provision and maintenance of motor vehicle fleets for government departments
- IT for the provision, maintenance and upgrading of IT equipment for government departments
- World Heritage Site, for the design, construction, maintenance and operation of the Cradle of Humankind World Heritage Site
- Rapid Rail, for the partial financing, design, construction, maintenance and operation of a Rapid Rail System
A PPP is –

- A contract between public sector (institution) and private sector (private party), where the

- Private party performs an institutional function and/or uses state property in accordance with output specifications and where there is a

- Substantial transfer of financial, technical and operational risk to the private party and the

- Private party benefits through unitary payments by institution and/or user fees but the

- Institution retains major role as main purchaser of the services or as main enabler of the project
Typical PPP Structure

Government

PPP Agreement

Private Party (Special Purpose Vehicle) [SPV]

Equity

Shareholding

Subcontracts

Loan Agreements

Debt

Subcontractor e.g. Construction

Subcontractor e.g. Operations
Parties’ Interests

Institution
- Affordability
- Transfer of risk
- Value for money

Private Party
- Repay debt and earn equity return
- Contractor-sponsor-shareholder
- Operator-sponsor-shareholder
Significance of Risk Allocation

• Essence of PPPs is analysis and allocation of project risks

• Essential for all parties to thoroughly review and address all the risks

• Many areas for potential conflict – reconciliation of various parties’ interests
Fundamental Principles

- A risk should be borne by the party best able to manage that particular risk
- Back-to-back risk allocation
- Avoid residual risks in private party – “insulate” the SPV
- Risk mitigation essential
- Importance of insurance
Risk and PPP Project Cycle

- Allocating risk
  - Feasibility study
  - TVR-I - draft PPP agreement, incorporating Standardised PPP Provisions and Standardised risk matrix

- Quantifying risk
  - Feasibility Study
  - Value assessment: constructing the risk-adjusted PSC and PPP reference models
Categories of Project Risk

1. Market, demand or volume risk
2. Construction risk
3. Operating risk
4. Political risk
5. Environmental risk
6. Financial risk
7. Regulatory risk
Market, Demand or Volume Risk

• Demand side: insufficient income
  – Poor demand
  – Falling prices
  – No scope for increasing prices

• Supply side
  – Increased costs of inputs
  – Unavailability or scarcity of supply
Mitigating Market, Demand or Volume Risk

- PPP agreement
  - Authority to increase unitary payment or tariffs
  - Extension of project term

- Specialist advisors

- Business interruption insurance
• Construction subcontractor entity (construction joint-venture)
• Overruns (cost and/or time)
• Design risk: quality specifications met
• Site risk
Mitigating Construction Risk

• Construction subcontractor JV agreement
  – Joint and several liability

• PPP agreement
  – Institution responsibility for expropriation
  – Performance bond / letter of credit
  – Liquidated damages

• Construction subcontract
  – No residual construction risk with private party
  – Fixed price

• Insurance
- Cost overruns
- Industrial action
- Failure to obtain necessary consents or rights
- Failure to meet operating performance criteria / output specifications
- Technology
Technology Risk
Mitigating Operating Risk

• Operations subcontractor JV agreement
  – Joint and several liability

• Operations subcontract
  – No residual operations risk with private party
  – Fixed price
  – Interface with construction subcontract

• Insurance
Political Risk

- Institution’s creditworthiness / sovereign debt defaults
- Nationalisation
- Expropriation
- Privatisation
Mitigating Political Risk

- PPP agreement
  - Relief for “Unforeseeable Discriminatory Government Conduct”
  - Breach clause
  - Termination clause
  - Lenders’ step-in rights under a direct agreement
Environmental Risk

- Legal liability
  - The Constitution
  - National Environmental Management Act 1998
  - Environment Conservation Act 1989

- Regulatory bodies
Mitigating Environmental Risk

- Insurance

- Due diligence
  - Party conducting it
  - Environmental Impact Assessment
  - Environmental Management Plan

- Construction and operations subcontracts
  - Environmental management
  - Indemnification
Financial Risk

- Inflation risk
- Interest rate risk
- Foreign exchange risk
Mitigating Financial Risk

• Hedging
  – Exchange rates
  – Interest rates
  – Commodity prices

• Fixed rate loans

• PPP agreement
  – Revenue adjustment formula
  – Escalation / indexation
• Capacity to contract
• Well-developed body of commercial law
• Consistent application and interpretation
• Independent judiciary
• Security of tenure and title
• Enforceability of project documents
Mitigating Regulatory Risk

- Attorneys
  - Local counsel
  - Legal due diligence and legal opinion

- Choice of law

- Jurisdiction

- Alternative dispute resolution mechanisms
### Conventional PPP Risk Matrix

<table>
<thead>
<tr>
<th>Risk Type</th>
<th>Private party</th>
<th>Contractor</th>
<th>Operator</th>
<th>Lenders</th>
<th>Institution</th>
<th>Insurers</th>
<th>Sponsors</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Market risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2) Design risk</td>
<td></td>
<td></td>
<td></td>
<td>*</td>
<td></td>
<td>*</td>
<td></td>
</tr>
<tr>
<td>3) Construction risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>*</td>
</tr>
<tr>
<td>4) Operating risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>*</td>
</tr>
<tr>
<td>5) Political risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6) Environmental risk</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td></td>
<td></td>
<td></td>
<td>*</td>
</tr>
<tr>
<td>7) Inflation risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>*</td>
<td></td>
</tr>
<tr>
<td>8) Interest rate</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>*</td>
<td></td>
<td>*</td>
</tr>
<tr>
<td>9) Exchange rate risk</td>
<td></td>
<td>*</td>
<td></td>
<td></td>
<td></td>
<td>*</td>
<td>*</td>
</tr>
<tr>
<td>10) Regulatory risk</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td></td>
<td></td>
<td>*</td>
<td>*</td>
</tr>
</tbody>
</table>
## Bloemfontein Prison – Risk Allocation Example

<table>
<thead>
<tr>
<th>Technical / Operational Risk Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Risk Type</strong></td>
</tr>
<tr>
<td>Construction – Design</td>
</tr>
<tr>
<td>Construction – Cost</td>
</tr>
<tr>
<td>Construction – Delays</td>
</tr>
<tr>
<td>Change in Technology</td>
</tr>
<tr>
<td>Operating Costs</td>
</tr>
<tr>
<td>Damage to prisons</td>
</tr>
<tr>
<td>Prison Security</td>
</tr>
<tr>
<td>Cell Availability</td>
</tr>
<tr>
<td>Cell Usage</td>
</tr>
<tr>
<td><strong>Legal / Financial Risk Allocation</strong></td>
</tr>
<tr>
<td><strong>Risk Type</strong></td>
</tr>
<tr>
<td>Capital Outlay</td>
</tr>
<tr>
<td>Interest Rates</td>
</tr>
<tr>
<td>Inflation</td>
</tr>
<tr>
<td>Available Cash Flow</td>
</tr>
<tr>
<td>Residual Market Value</td>
</tr>
<tr>
<td>Financial Viability</td>
</tr>
<tr>
<td>Change in Tax Legislation</td>
</tr>
<tr>
<td>Change in Prison Legislation / MAGA</td>
</tr>
<tr>
<td>Land</td>
</tr>
<tr>
<td>Environmental</td>
</tr>
</tbody>
</table>
• Risk analysis crucial

• Due diligence process with integrity

• Challenge to develop an appropriate risk matrix, reconciling all parties’ interests
James Aiello
GTAC
240 Madiba Street
Pretoria
South Africa

Tel: +27 12 315 5298
Fax: +27 12 315 5477
www.ppp.gov.za
www.treasury.gov.za